EXPERIENCE WITH TAX REFORM IN THE REPUBLIC OF KOREA

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How can a tax system be designed to "optimally" raise revenue to finance necessary government expenditures? This question must be at the centre of the economic policies in many countries. In developing economies, one more function is required – that is, taxation itself must promote rapid economic growth. In other words, taxation should raise the required funds, and promote economic growth, presumably with tax incentives, while at the same time satisfying the so-called principles of taxation – efficiency, equity and simplicity. In this paper, the author describes past tax reforms in the Republic of Korea and evaluates them. They are evaluated in relation to five aspects: impact on tax revenue, on growth, on equity, on efficiency and on simplicity. In addition, suggestions for future tax reforms are given.

I. BRIEF HISTORY OF TAX REFORMS

From independence to the war rehabilitation period[1]

Like many other countries in the world, the history of taxation in the Republic of Korea conforms with that of capitalist development in the country. In this sense, the embryonic tax system in the Republic of Korea was already formed in the late 19th century. It was then further developed and distorted concurrently during Japanese domination.

That system, however, was far from "modern." A modern tax system in the country was only introduced in 1948, when the first government of the country was formed. In that year, a tax law committee was founded and eight fundamental tax acts were enacted. Major acts included the Income Tax Act, Corporation Tax Act, and Liquor Tax Act. After that, ten additional tax acts, including the Inheritance Tax Act and Commodity Tax Act, were enacted.

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1 This period classification, along with those of the subsequent sections, follows the classifications used in Choi and Han (1992).

A number of changes in taxation were needed due to the war (1950-1953). These changes were particularly aimed at providing the additional revenue required to finance the war. In this regard, the Land Tax Act and Temporary Tax Revenue Expansion Act were introduced in 1950, while a number of existing tax acts, such as the Income Tax Act, were revised. As the war continued, further reform of the tax system, especially with respect to collection, was done. For this, the Special Measure for Taxation and the Temporary Land Income Tax Act were enacted in 1951. As a result, the land income tax replaced the general income tax as the main source of tax revenue.

With the armistice in 1953, emergency wartime tax measures were adjusted to a normal peacetime tax system, especially to meet the needs of economic reconstruction. For this purpose, the government of the Republic of Korea sought the help of foreign experts. As a result, H.P. Wald's Report and Recommendations for the Korean Tax System was published in August 1953.

Following the suggestions of Wald's report, reform of the tax system was put into effect. The Special Measure for Taxation and the Temporary Tax Revenue Expansion Act were abolished, while the textile tax was absorbed into the commodity tax and the license tax was transferred from the central government to local authorities. The income tax system was divided into specific taxes with flat rates and global taxes with progressive rates.

In order to increase tax revenue, the government introduced three new taxes in 1958: an education tax which was levied as a surtax to the personal income tax, an asset revaluation tax, and a foreign exchange tax. This last tax, introduced to absorb gains resulting from the difference between the official and market exchange rates, was abolished in 1963.

In the tax reform initiated by the Democratic Party government in 1960, direct tax rates were generally reduced, but indirect tax rates were raised, and tax exemptions and deductions designed to promote exports and capital accumulation were increased substantially.

The take-off period

In 1961, right after the coup, the military government began to work on structural tax reform and measures to improve tax administration. It enacted the Temporary Measure for Tax Collection and the Special Measure for Tax Evasion Punishment in order to collect delinquent taxes. The government also revised the Income Tax Act, the Corporation Tax Act, and the Business Tax Act, and established a new tax accounting system.

Then, at the end of the same year, the government implemented a general tax reform with emphasis on eliminating irregularities within the tax administration, laying the foundation for a lasting, modern tax system, and providing strong support for the

First Five-Year Economic Development Plan. It was the first time that the role of taxation was extended to areas other than just securing enough funds. This new role of taxation, i.e. the promotion of rapid economic growth, was given the central position in tax policy until the early 1980s, when the main focus of economic policy was changed. The other important characteristic of this reform was the streamlining of the local tax system.

Almost all the major tax acts were revised. As a result, the total number of taxes was reduced to 28 from the previous 38. Then in 1962, the Adjustment Law for National and Local Tax and the National Tax Appellate Application Law were introduced. These tax reforms in 1961-62 are regarded as establishing many of the features of the present tax system in the Republic of Korea.

In 1966, there was an important change in the tax administration of the country. On March 3rd of that year, the National Tax Service (NTS)[2] was established. Its main functions have been the assessment and collection of internal taxes. The establishment of the NTS marked the beginning of modern tax administration.

There was another large scale tax reform in 1967. The aim of this reform was to promote rapid economic growth by supporting the Second Five-Year Economic Development Plan. Tax incentives were widely introduced, particularly for this purpose. Twelve of the 19 existing tax laws were modified extensively and a new Real Estate Speculation Control Tax Law was instituted. The most important characteristic of this reform was the introduction of the global income tax, although it was incomplete. A more complete form of the global income tax was introduced in the major tax reform of 1974, which will be discussed below. Finally, in an effort to enhance equity, the highest marginal rate of the inheritance tax was increased from 30 per cent to 70 per cent.

In 1974, the government undertook reform measures of the tax system, primarily to improve income distribution. Income redistribution was a particularly important policy issue at that time because it was widely recognized that the development strategy until then put too little emphasis on equity. The major features of the reform were as follows: a full-scale global income tax system was introduced as discussed above (see table 1 for the tax bases and rates). Generous personal exemptions were also allowed to reduce the tax burden of low income earners. A rate structure also lightened the tax burden of low income earners, and increased the burden on those in the high income brackets. A capital gains tax was introduced to replace the Real Estate Speculation Control Tax which had been in effect since 1968.

In December 1976, the government carried out a large scale tax reform and introduced the Value Added Tax (VAT) and Special Excise Tax. Eighteen new tax laws were enacted or amended under the reform as well. This tax reform was mainly

[2] At first, it was called the Office of the National Tax Administration (ONTA) and then the National Tax Administration (NTA).

Table 1. Comprehensive income tax rates (1974)

(Unit: thousand won, per cent)

Comprehensive income tax base		*Tax rates*
Over	*Not more than*	
0	240	6
240	480	10
480	720	12
720	960	15
960	1 200	18
1 200	1 500	21
1 500	1 800	25
1 800	2 400	30
2 400	3 000	35
3 000	4 800	40
4 800	7 200	45
7 200	12 000	50
12 000	24 000	55
24 000	36 000	60
36 000	48 000	65
48 000		70

aimed at improving stable national life, meeting the fiscal requirements of the Fourth Economic Development Plan, and further modernizing the tax system. The last objective, that is, modernization of the tax system, is regarded as being accomplished by this reform.

The 1976 amendments to the internal tax laws generally went into effect in January 1977, except for the Value Added Tax Law and the Special Excise Tax Law, which went into effect on 1 July 1977. By this reform, the traditional indirect tax system, which included a cascade-type business tax, was replaced by a consumption-type VAT and a supplementary special excise tax. This was primarily to simplify tax administration and promote exports and capital investment. A single, flexible rate of 10 per cent was applied to all items subject to VAT. The entertainment and food tax, which had been a local tax item, was incorporated into the national tax system. The registration tax, which had been treated as a national tax, was converted to a local tax starting 1 January 1977.

The liberalization and stabilization period

There was a dramatic economic policy change in the 1980s. Following the second oil crisis in 1979 and the political turmoil of 1979 and 1980, the economy of the Republic of Korea was plunged into a deep recession. Under these new circumstances, the government switched its economic policy directions fundamentally: from protection to competition and openness, and from regulation to liberalization and bold privatization. In this regard, the government began to reduce its intervention in the private sector. As a result, not many new functions were demanded from taxation.

Therefore, unlike the 1960s and 1970s, there were no major tax changes during the 1980s, up to 1987, although there were minor revisions of tax laws. In this period, major changes were made in two areas – tax incentives and the curbing of land price hikes.

During the course of rapid economic growth, strategic industries were provided with a variety of tax incentives under many different schemes. The successive addition of new industries, firms, or individuals to the list of beneficiaries, and new types of incentives to the existing stock of incentive schemes complicated the tax system, generated inequities in the tax burden among individuals and sectors, and lessened the influence the tax preference measures could exert. In 1982, the government took its first step towards streamlining the tax incentive system. This will be discussed further in the next section.

The centerpiece of the tax reform in the late 1980s was how to control land speculation through tax measures. Speculation on land has been a serious economic and social problem in the Republic of Korea and the resulting land price hike caused much distortion in resource allocation and in the distribution of income and wealth.

To solve this problem, various measures – mostly tax-based – were taken. Most important among these was the aggregate land tax (the global landholding tax) which was introduced in 1989. This tax replaced the excessive land holding tax which had been in effect for the previous two years. Also, the so-called "public concept" of the ownership of land was introduced. To meet this principle, the increased rate of land tax was introduced in 1989, together with such non-tax measures as the Excessive Residential Land Ownership Charge and the Land Development Charge. Other major non-tax measures to curb the land price hikes included the introduction of a new system of assessing land: an upward adjustment of the assessment ratio.

Contrary to their intention, however, these measures are judged as (relatively) unsuccessful in their fight against land price hikes. As a result, all three measures related to the public concept of land were abolished in the late 1990s.

The government finally introduced the real name financial transaction system in August 1993. The tax measure related with this is the inclusion of the financial income in excess of 40 million won into the global income tax base. It was announced that this would be enacted in the tax reform in 1994. This measure, however, was suspended in 1998 amidst the economic crisis, and is supposed to be reintroduced in 2001.

In 1994 and 1995, there were major tax reforms in the Republic of Korea. The 1994 tax reform was designed to establish an advanced tax system which is characterized by low tax rates and a broader tax base in line with the tax reform in the United States in 1986.

Among many measures to achieve these goals, the most important ones are as follows: first, income tax became closer to a comprehensive income tax by incorporating interest and dividend income into the global income tax system (this has been applied since the beginning of 1996). Until 1995, interest and dividend income were assessed and withheld at a rate of 20 per cent, separate from global income.

Second, the self-assessment system for individual income taxes was introduced and went into effect on income reported in 1996. This would have indeed been an important improvement in tax administration if it had proceeded as intended. The reality, however, is that government-assessment is widely used even now.

Finally, corporation tax rates were reduced to improve the international competitiveness of domestic industries. As a result, the corporation tax rate of firms whose incomes were greater than 100 million won per year was reduced to 30 per cent from the previous 32 per cent.

Tax law amendment in 1995 was in line with that of the previous year, that is, lowering the tax burden and widening the tax base. For this, individual income tax brackets were adjusted (see table 2). At the same time, the corporation tax rate was further reduced by 2 per cent (see table 3).

Table 2. Individual income tax brackets (1995)

Tax rate (per cent)	*Brackets*	
	Before	*Revised*
10	10 million won	10 million won
20	10 30	10 40
30	30 60	40 80
40	60	80

Table 3. Change in corporation tax rate

Tax year	*Tax rate (private corporations)(per cent)*
1995	income 100 million won: 18 (19.35)
	income 100 million won: 30 (31.50)
1996	income 100 million won: 16 (17.20)
	income 100 million won: 28 (30.10)

Financial crisis and tax reform: 1998-1999

The economic crisis which started in late 1997 forced the government to initiate a series of comprehensive economic reform measures to overhaul the economy. As a part of such reforms, the government made a number of changes in tax laws to facilitate the restructuring process, stimulate investment and consumption, and broaden the tax base and tax revenue.

Measures for restructuring

One of the most important causes behind the crisis was too much debt owed by firms. Thus, the financial restructuring of the corporate and financial sectors was inevitable to overcome the crisis. In this sense, the tax liability should neither discourage nor prevent companies and financial institutions from undergoing the necessary restructuring. Therefore, the government exempted or reduced taxes on asset transactions that are needed for corporate and financial restructuring.

Tax incentives to encourage and accelerate restructuring were mostly granted to transaction-related taxes, such as the Capital Gains Tax, Acquisition Tax, and Registration Tax. These incentives are to encourage corporate mergers and acquisitions, business divisions, asset swaps, alienation of business assets, and contributions by company owners. For example, profits resulting from the revaluation of corporate assets after mergers and acquisitions have been made eligible for deferral from corporate income tax until the alienation of the revalued assets. Corporate mergers and acquisitions have also been exempted from the Registration Tax.

Stimulating investment and consumption

The withdrawal of foreign capital was one of the principal factors that precipitated the Republic of Korea's economic crisis. Therefore, restoring the confidence of foreign investors and attracting foreign investment were overriding priorities. To attract foreign direct investment (FDI), the Foreign Investment Promotion Act (FIPA) was enacted in 1998. In May 1999, provisions dealing with tax incentives for FDI was subsumed into the Special Tax Treatment Control Law (STTCL).

The principal objective of FIPA is to attract FDI by creating a more liberalized and favourable business environment for foreign businesses and providing tax incentives to certain types of FDIs. Under FIPA, foreign businesses and investors who make advanced technology FDI in the Republic of Korea have been made eligible for exemptions from individual and corporate income taxes for the first 7 years and 50 per cent reductions for the next three years. In addition, foreign businesses and investors have been granted exemptions from a number of local taxes (i.e., Acquisition Tax, Property Tax, Aggregate Land Tax, and Registration Tax) for a minimum of 5 years and 50 per cent reductions for the next 3 years. Imported capital goods have also been made eligible for full or partial exemptions from customs duties, the special excise tax, and VAT.

As an additional measure to attract FDI, the long-protected real estate market in the country was completely opened to foreign investors in June 1998. In an effort to attract large-scale foreign investment, the government also introduced a Foreign Investment Zone (FIZ) system. Foreign investment companies that receive the FIZ designation are eligible for government support and tax benefits.

Tax incentives were provided to small and medium-sized enterprises to stimulate employment and technology investment. They include tax exemptions on stock options, tax credits and exemptions on R&D, reduction of special excise tax on consumer electronic goods and automobiles, reduction of automobile tax, and reduction of capital gains tax.

Broadening tax bases and increasing tax revenue

Tax revenue has decreased significantly since the beginning of 1998 due to the recession. On the other hand, a sharp increase in government spending was necessary, particularly to meet part of the cost of restructuring, unemployment benefits, and social safety nets. These naturally led to a huge fiscal deficit.

To prevent an excessive deficit, the government raised tax rates on items that were believed to have been least affected by the economic crisis. Thus, among others, taxes on gasoline and diesel were raised, and the progressive taxation of interest income was switched to a proportional withholding tax. In addition to these, cigarettes became subject to VAT on top of the existing local tax.

In an effort to broaden the tax bases, the government also curtailed tax exemptions and reductions. One notable example is the abolition of the VAT exemption on services supplied by professional service providers, e.g., lawyers and accountants. Also, the government enacted the Special Tax Treatment Control Law to control the widely scattered exemption-related laws, making tax laws that allow exemptions and reductions subject to sunset rules.

II. EVALUATION OF TAX REFORMS

Tax revenue

As was pointed out, the major function of taxation is to secure enough funds for expenditures. It needs to be seen whether taxation in the Republic of Korea, with its many past reforms, has served this purpose well. As a result of much effort by the government to raise revenue, the share of total (national and local) tax revenue as a percentage of GNP, or the tax burden, increased from 6-7 per cent in the mid-1950s to 20-21 per cent in the 1990s, as can be seen in table 4. The overall tax burden as a percentage of GNP, however, is still considered to be low compared to that of other countries.

Table 4. Total tax revenue as a percentage of GNP

Year		*Year*		*Year*	
1955	6.2	1970	14.3	1985	17.3
1956	6.0	1971	14.4	1986	17.0
1957	7.5	1972	12.5	1987	17.5
1958	8.6	1973	12.1	1988	17.9
1959	10.2	1974	13.4	1989	18.5
1960	10.3	1975	15.3	1990	19.7
1961	9.7	1976	16.6	1991	19.3
1962	10.6	1977	16.6	1992	18.7
1963	8.6	1978	17.1	1993	18.9
1964	7.1	1979	17.4	1994	19.9
1965	8.6	1980	17.9	1995	20.7
1966	10.7	1981	18.0	1996	21.3
1967	12.0	1982	18.2	1997	21.3
1968	13.9	1983	18.5	1998	22.9
1969	14.6	1984	17.7		

Source: National Bureau of Statistics, *Major Statistics of the Korean Economy*, 1998.

The increasing trend in the tax burden was not smooth until the mid-1960s. This was due partly to fluctuations in economic activity and partly to revenue losses from extensive tax incentives and major tax reforms that reduced the tax rates of the personal and corporate income taxes and increased exemption levels of the personal income tax. For example, the fall in the tax burden ratio in 1963-65 was caused by the bad performance of the economy in the early 1960s.

This trend, however, became stable after the establishment of the NTS, except for the decrease in the tax burden during 1972-73. That is believed to be the result of the extensive tax reforms and the Emergency Decree on Economic Stabilization and Growth (the so-called "August 3rd Special Measure") in 1972.

As was mentioned in the previous section, the establishment of NTS was a turning point in the history of tax administration in the country and contributed to the revenue increase. One interesting point is that the tax burden ratio increased even in a deep recession. Cooper (1994) argued that this may be due to the target revenue approach adopted by the NTA. In other words, a more stringent effort to collect tax revenue would be made if a decrease in the revenue is expected due to a recession.

Although the tax burden in the Republic of Korea has been relatively light, the fiscal balance of the country was very sound (see table 5), until it was hit by the economic crisis in 1997. This phenomenon reflects two facts about the role of the

Table 5. Budget surplus or deficit

(Unit: 100 million won)

Year	*General Account*	*per cent of GDP*	*Consolidated Budget*	*per cent of GDP*	*GDP*[2]
1972	239	0.6	-1 925	-4.6	42 119
1975	882	0.9	-4 661	-4.5	102 955
1980	3 192	0.8	-11 737	-3.1	381 484
1981	2 342	0.5	-21 109	-4.4	476 567
1982	-582	-0.1	-22 221	-4.1	547 210
1983	2 486	0.4	-9 506	-1.5	641 965
1984	1 890	0.3	-9 229	-1.3	736 051
1985	-472	-0.1	-7 133	-0.9	820 621
1986	2 605	0.3	-649	-0.1	957 364
1987	11 132	1.0	2 597	0.2	1 121 303
1988	20 180	1.5	16 427	1.2	1 331 342
1989	4 314	0.3	-191	0.0	1 491 647
1990	2 126	0.1	-15 782	-0.9	1 787 968
1991	-17 354	-0.8	-40 220	-1.9	2 165 109
1992	1 452	0.1	-17 029	-0.7	2 456 996
1993	4 341	0.2	8 129	0.3	2 774 965
1994	17 218	0.5	13 843	0.4	3 234 071
1995	11 119	0.3	12 415	0.3	3 773 498
1996	3 618	0.1	10 990	0.3	4 184 790
1997	-3 950	-0.1	-69 590 [1]	-1.5	4 532 764
1998	-8 366	-0.2	-187 570	-4.2	4 495 088

Source: National Statistical Office, Korean Statistical Information System.

Note: [1] In 1997, includes foreign borrowing of US$ 5 billion dollars from IBRD and ADB.

[2] At current prices.

government in the past: first, it has led rapid development through non-fiscal measures such as direct intervention, regulation, policy loans, etc. Second, there has been oversuppression on all or part of government expenditures.

Part of the oversuppression was on expenditures on social welfare. It is also to be noted that the social security system in the country has not been developed sufficiently until recently. The fully funded national pension, which was introduced first, has not paid full scale benefits yet. Also medical insurance and unemployment insurance are still in their initial stages.

Impact on growth

One of the major functions of fiscal policy is to stimulate economic growth. Particularly for less developed countries, it is believed that governments should provide tax incentives for savings, capital formation, and export promotion to achieve rapid economic growth. Indeed, in such growing economies as the Republic of Korea, the above-mentioned tax incentives have been widely used. What interests us is whether the country's taxation, with many of those incentives, contributed much to the rapid economic growth of the country.

Although there has been much talk about this, rigorous analyses of the impact on growth are rare. The most prominent among them must be those of Trella and Whalley (1991, 1992). These analyses are based upon their two (1991) and three (1992) sector CGE models. Since they are the only meaningful analyses on this subject to the best of the author's knowledge, our evaluation here will be centred around these papers.

According to Trella and Whalley, tax reforms in the Republic of Korea have "probably facilitated rather than fueled high growth." This conclusion is based on their findings that the GDP growth rate in each of the phases in which the major tax regime changes have occurred has been consistently high.

What is more important is their second conclusion in the second paper. They concluded that taxation in the Republic of Korea has played a relatively modest role, accounting for 3.0 to 4.2 per cent of the country's growth between 1962 and 1982, with only 3.6 per cent between 1962 and 1972. This is equivalent to a 0.26 percentage point contribution to the growth rate over the period 1962-1982 (which is about half of the counterpart in the two sector model).

Thus, the contribution of taxation to the growth rate is indeed small. This interpretation, however, is open to criticism. Krueger (1992) raises this question in her comment to the paper. She started with noting the fact that half a percentage point on the growth rate for many other countries would be a major achievement. Moreover, it does not count the secondary effects of taxation, e.g. reducing the budget deficit and the rate of inflation. Therefore, she argues that the isolated direct effect of taxation, excluding all of these derived effects, cannot be small. In other words, taxation may have had a substantial effect on the Republic of Korea's growth, contrary to Trella and Whalley's conclusion.

It would be very difficult, however, to analyse the true contribution of taxation capturing all of these effects. International comparison may be needed. It should be admitted that taxation has certain limits as a tool for growth, considering the fact that its primary function is the provision of funds for the public good. Taking this into account, it is more appropriate to see whether taxation has contributed more to growth than other policy tools. We now turn to this subject.

There have been so many tax incentives in the country that we cannot even list all of them here. The most important among them are special depreciation, investment tax credit and tax free reserves. A tax holiday was extensively used until its abolition in 1981 (see the appendix for a more detailed explanation of tax incentives in the Republic of Korea).

In the 1960s, the core of the Republic of Korea's development policy was export promotion, and naturally the greatest emphasis was placed on those tax incentives designed to promote foreign exchange earning activities. In this period, a tax holiday was the most important tax incentive until the investment tax credit was introduced in 1967. The government's efforts to promote exports in the 1960s were highly successful, and investment in light manufacturing export industries grew rapidly. It is, however, very difficult to measure the net effect of tax incentives because at the same time, very strong credit support, such as policy loans, was provided to the export industries.

What are the impacts of such tax incentives? Have they really contributed much to the growth of the economy as intended? The answer is neither in the affirmative nor negative. Almost all the research on the cost of capital and effective corporation tax rates in the Republic of Korea points out that they have been somewhat effective, but not very much (Kwack and Yoo (1994), and Yoo (1998)). Yoo (1995) showed that investment tax credits and accelerated depreciation were powerful. Other measures, particularly the policy loans, have been argued to be far more effective than tax incentives (see Cho and Kim 1994).

Finally, it should be pointed out that the structure of tax incentives in the country is very complicated and difficult to interpret. This aspect along with the efficiency of the tax incentives will be discussed later in the paper.

Equity

It goes without saying that equity is one of the most important factors in evaluating taxation. It is said, however, that taxation in the Republic of Korea leaves much to be desired in equity, both vertical and horizontal. Despite continuous efforts by the government, the equity of taxation has not improved much.

It is appropriate to look in this context at the tax structure of the country, including the revenue structure first, because it is the outcome of tax reforms. In other words, it essentially reflects the appropriateness of tax reforms. Currently, there are 16 national taxes including customs duties, and 15 local taxes (see figure A1 in the appendix). It is often criticized that there are too many taxes which in turn causes the complexity of the tax system.

If we look at the composition of taxes the major revenue sources of the central government are consumption and income taxes while those of the local government are property related taxes. Since its introduction in 1977, VAT has became a major source of revenue in the Republic of Korea. As shown in table 6, VAT yielded 24.3 per cent of total national tax revenue, making it the largest single tax in the country. Although it ceded its position to personal income tax in 1998, due to the recession after crisis, the switch was reversed again in 1999 according to tentative figures.

Taxes on wealth at the central government level, such as the inheritance and gift tax, assets revaluation tax, and securities transaction tax are hardly significant in terms of their revenue yield. Revenue collected from the above taxes comprise only 2.1 per cent of the central government's total tax revenue in 1998. Wealth taxes at the local government level such as the acquisition tax, property tax, registration tax,

Table 6. The tax system in the Republic of Korea (1997-1998)
(per cent)

National taxes	*Share in total taxes*		*Share in national taxes*		*Local taxes*	*Share in local taxes*		*Share in local taxes*	
	1998	*1997*	*1998*	*1997*		*1998*	*1997*	*1998*	*1997*
1. Domestic taxes	60.7	60.9	75.6	75.9	1. Ordinary taxes	17.7	17.8	89.6	90.3
Personal income tax	20.4	19.2	25.4	23.9	Acquisition tax	2.9	3.3	14.6	16.8
Corporation tax	12.8	11.1	15.9	13.8	Registration tax	3.8	4.6	19.3	23.2
Inheritance and gift tax	0.8	1.3	1.0	1.6	License tax	0.3	0.3	1.4	1.6
Assets revaluation tax	0.5	0.2	0.7	0.3	Inhabitant tax	3.0	2.6	15.3	13.4
Excessive land holding tax	0.0	0.0	0.0	0.0	Property tax	0.7	0.6	3.8	3.1
					Automobile tax	2.5	2.1	12.5	10.6
Excess profit tax	–	–	–	–	Farmland income tax	–	–	–	–
Value-added tax	18.6	20.7	23.2	25.8	Butchery tax	0.1	0.0	0.3	0.2
Special consumption tax	2.6	3.7	3.3	4.7	Horse race tax	0.4	0.3	2.1	1.8
Liquor tax	2.1	2.3	2.7	2.9	Tobacco tax	2.6	2.4	13.2	12.3
Telephone tax	1.1	0.8	1.4	1.0	Aggregate-land tax	1.4	1.4	7.2	7.3
Stamp tax	0.4	0.4	0.4	0.6					
Securities transaction tax	0.3	0.4	0.4	0.5	2. Earmarked tax	1.7	1.6	8.7	8.6
Carry-over	1.1	0.7	1.4	0.9	City planning tax	0.9	0.8	4.5	4.1
					Fire service facilities tax	0.3	0.3	1.8	1.4
2. Customs duties	4.5	6.7	5.7	8.3	Workshop tax	0.4	0.4	2.0	1.9
					Regional development tax	0.1	0.1	0.4	0.4
3. Surcharges	15.1	12.6	18.8	15.8					
Education tax	6.2	5.8	7.7	7.3					
Transportation tax	7.7	5.5	9.6	6.9	3. Carry-over	0.3	0.4	1.8	1.8
Special tax for rural development	1.2	1.3	1.5	1.6					

Source: Bank of Korea, *Economic Statistics Yearbook*, 1999.

city planning tax, fire service facilities tax and automobile tax are major fiscal resources for local governments, accounting for 56.5 per cent of their total tax revenue. Revenue from wealth taxes as a percentage of total tax revenues of both governments at all levels, however, is about 12.7 per cent, which is not very high by international standards.

As can be seen in table 7, which shows the structure of the national tax system, the Republic of Korea once heavily depended on domestic indirect taxes on goods and services which accounted for 52.4 per cent of total tax revenue of the central government in 1980. In the 1990s, however, its share drastically decreased to around 38 per cent. On the other hand, taxes on income and profits accounted for only 36.0 per cent of the total national tax revenue in 1994. This is an increase compared to the 25 per cent level in the late 1970s. Although income taxes have gained importance in recent years, income taxes do not occupy the central position in the revenue structure of the country. The share of taxes on international transactions, entirely composed of customs duties on imports in the Republic of Korea, has also gradually decreased to 4.9 per cent in 1998 from 17.2 per cent of the central government revenue in 1980.

These facts, i.e., the largest share captured by VAT, the relatively low shares of income and property taxes, explain one important characteristic of the structure of tax in the country. It is that the government relies very heavily on indirect taxes. As

Table 7. Structure of national taxes, 1970-1998
(per cent)

	Percentage of total national taxes									
	1970	*1975*	*1980*	*1985*	*1990*	*1994*	*1995*	*1996*	*1997*	*1998*
Taxes on income, profit and capital gains	35.0	24.3	25.5	28.7	37.5	36.0	35.9	33.3	33.0	35.7
Social security contributions	0.8	1.0	1.2	1.7	5.1	8.8	8.7	10.3	10.2	13.4
Taxes on property	2.5	3.9	0.6	0.7	2.4	3.2	2.6	2.0	2.1	1.8
Taxes on goods and services	46.5	51.1	52.4	49.0	38.4	38.5	37.0	38.0	37.6	34.7
Taxes on international transactions	13.8	14.4	17.2	16.2	13.0	6.7	7.4	7.3	7.3	4.9
Other taxes	1.3	5.5	3.0	3.8	3.6	6.8	8.4	9.1	10.0	9.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance and Economy, Government Finance Statistics in Korea, 1980, 1991, 1995, 1997, 1999.

shown in the second column of table 8, more than 70 per cent of total tax revenues, national and local, were revenues from indirect taxes until the mid-1980s, though the share decreased to 64 per cent in the 1990s.

What do these shares imply? They imply that taxation in the country is still considered to be vertically inequitable because indirect taxes are more regressive than direct taxes. As a matter of fact, most tax incidence research has shown that direct taxes are progressive while indirect taxes are slightly regressive.

Table 8. Characteristics of the tax structure, 1970-1997 (per cent)

	Direct taxes to total taxes[1]	*Indirect taxes to total taxes*[2]	*National taxes to total taxes*	*Local taxes to total taxes*	*Local taxes to GNP*
1970	33.9	66.1	91.7	8.3	1.2
1971	36.9	63.1	91.9	8.1	1.2
1975	25.8	74.2	89.8	10.6	1.6
1976	29.6	70.4	90.5	9.5	1.6
1980	25.2	74.8	88.3	11.7	2.1
1981	25.7	74.3	88.9	11.1	2.0
1982	26.0	74.0	88.2	11.8	2.2
1983	24.5	75.5	87.8	12.2	2.4
1984	24.8	75.2	87.8	12.2	2.3
1985	27.8	75.2	87.8	12.2	2.1
1986	27.3	72.7	88.3	11.7	2.0
1987	29.8	70.2	88.2	11.8	2.1
1988	33.3	66.7	86.3	3.7	2.5
1989	36.5	63.5	81.8	18.9	3.5
1990	35.9	64.1	80.8	19.2	3.6
1991	35.8	64.2	79.1	20.9	3.7
1992	36.0	64.0	78.8	21.2	4.0
1993	35.7	64.3	78.1	21.9	4.1
1994	35.7	64.3	78.1	21.9	4.3
1995	37.6	62.4	78.8	21.2	4.4
1996	35.9	64.1	80.3	19.7	4.0
1997	33.8	66.2	80.3	19.7	4.3

Sources: Bank of Korea, Economic Statistics Yearbook, 1991, 1996, 1998.
Ministry of Finance, Government Finance Statistics in Korea, 1991.
National Bureau of Statistics, Major Statistics of the Korean Economy, 1991.

Notes: [1] The classification of direct and indirect taxes is based on national income accounts.
[2] General sales tax in Korea before July 1977 was the ness tax, which was replaced by the VAT.

There is considerable research on tax incidence in the Republic of Korea. Since conducting new research or a full scale analysis of tax incidence is beyond the scope of this paper, the results of previous research are summarized below.

According to previous research, indirect taxes are generally regressive, except for the special excise tax. These results conform with our expectation. For example, Heller (1981), Han (1982), Hyun and La (1993), and Sung (1999) all showed such results (see table 9 and figure 1). For special excise tax, however, the results are split. Most of the research showed that the special excise tax is regressive, although this tax was introduced to offset the regressiveness of the VAT. Heller's result is somewhat mixed and should be interpreted as proportional. On the other hand, Hyun and La (1993) showed that this tax is progressive.

There is not much research on the incidence of direct taxes. Hyun and La (1993) and Sung (1999) all showed that income tax is progressive (see table 10 and figure 2). The latter have shown that the tax burden became more regressive after the crisis in 1997. For property tax, Kwack and others have shown that it is progressive under the "new" view, while it is regressive under, the "old" view (see table 11).

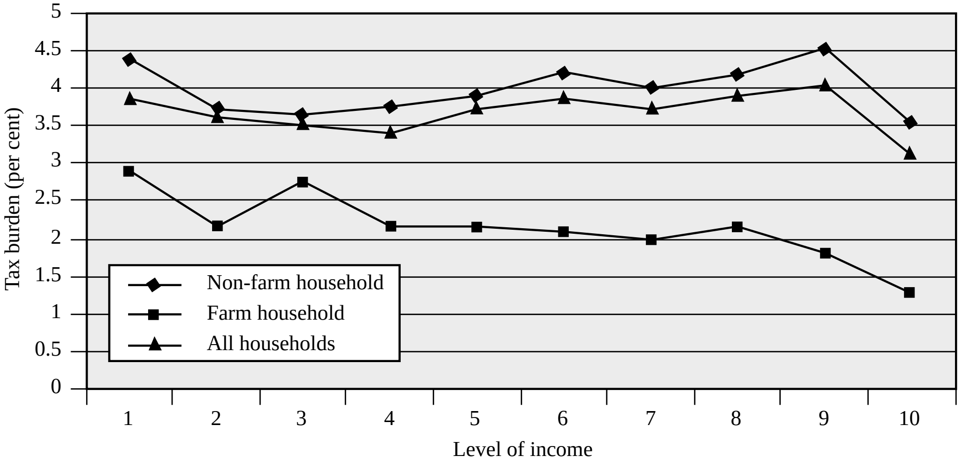
We have only talked about one part of equity – i.e. vertical. The country's tax system is regarded as horizontally inequitable as well. In particular, the inequality of the tax burden between the self-employed and employees is serious. Many analyses on tax evasion showed that more than 50 per cent of the income of the self-employed is not reported while that of employees is nearly fully revealed (see Yoo 1997).

Table 9. Indirect tax burden by taxes
(per cent)

	Special consumption tax		*Liquor tax*		*VAT*		*Indirect tax*	
	1984	*1991*	*1984*	*1991*	*1984*	*1991*	*1984*	*1991*
	0.61	0.37	0.25	0.24	4.31	3.77	7.34	4.39
	0.36	0.32	0.13	0.21	2.46	3.20	4.27	3.71
	0.36	0.34	0.12	0.20	2.30	3.05	3.95	3.64
	0.42	0.44	0.11	0.18	2.27	3.07	3.89	3.68
	0.34	0.55	0.12	0.15	2.16	3.21	3.59	3.91
	0.36	0.73	0.10	0.15	2.10	3.31	3.47	4.19
	0.39	0.66	0.10	0.13	2.05	3.23	3.37	4.02
	0.37	0.79	0.09	0.12	2.02	3.39	3.25	4.17
	0.38	0.97	0.08	0.09	1.97	3.45	3.10	4.52
	0.41	0.78	0.07	0.07	1.88	2.72	2.85	3.57
Average	0.39	0.69	0.10	0.13	2.10	3.15	3.41	3.95

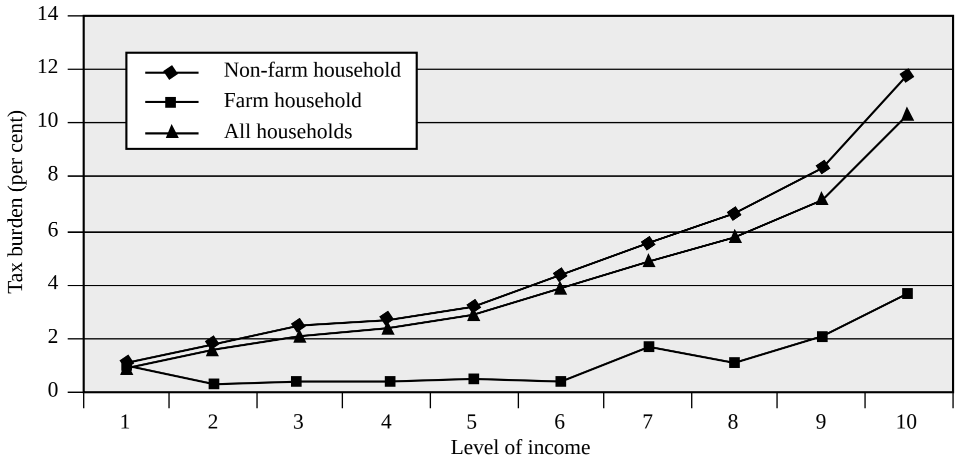
Source: Hyun, J. and S. La, *Analysis of Tax and Social Assistance Policy: Korean Tax-Benefit Model*, 1993.

Figure 1. Burden of indirect tax (1991)



Source: Hyun, J. and S. La, *Analysis of Tax and Social Assistance Policy: Korean Tax-Benefit Model*, 1993.

Figure 2. Burden of income tax 1991



Source: Hyun, J. and S. La, *Analysis of Tax and Social Assistance Policy: Korean Tax-Benefit Model*, 1993.

Table 10. Income tax burden 1991 (per cent)

	Non-farm households	*Farm households*	*All households*
	1.10	1.04	0.91
	1.85	0.31	1.58
	2.49	0.41	2.14
	2.75	0.41	2.44
	3.24	0.53	2.86
	4.36	0.44	3.85
	5.60	1.72	4.87
	6.67	1.13	5.77
	8.32	2.07	7.14
Average	11.75	3.68	10.26
Gini Index	6.64	1.74	5.79
Atkinson Index	0.2907	0.3241	0.2974
= 0.5	-6.3	-1.7	-5.2
	0.0725	0.0851	0.0749
= 0.9	-11.2	-3.3	-9.5
	0.1269	0.1472	0.1307
B-S Index	-10.4	-3.0	-8.8
Degree of progressiveness	0.9158	0.7328	0.8509
Degree of regressiveness	0.0173	0.0810	0.0182
Degree of retrogression	0.0669	0.1862	0.1308
Degree of horizontal equity	0.1336	0.1523	0.0878

Source: Hyun, J. and S. La, *Analysis of Tax and Social Assistance Policy: Korean Tax-Benefit Model*, 1993.

Table 11. Burden of property tax 1991

(Ratio to income tax)

Level of income	*Traditional aspect*			*New aspect*
	Total	*Land*	*Buildings*	*Total*
Average	0.80	0.46	0.34	0.68
	0.94	0.35	0.59	0.55
	0.66	0.23	0.43	0.35
	0.61	0.23	0.38	0.34
	0.67	0.30	0.37	0.45
	0.68	0.32	0.36	0.48
	0.74	0.39	0.35	0.58
	0.77	0.44	0.33	0.65
	0.81	0.49	0.32	0.72
	0.88	0.55	0.33	0.82
	0.88	0.62	0.26	0.94

Source: Kwak and others, *Reform Proposals for Property Holding Taxes – Concentrated on Land Tax*, Economic Policy Information Centre, 1991.

Efficiency and simplicity

It is hard to tell which tax is relatively efficient or not unless rigorous empirical research is done. Unfortunately, there has been little of that. In particular, research on the excess burden (or dead weight loss) which is essential to evaluate efficiency, is scarce. Thus, in this section, we will limit our discussion to the corporation tax by introducing analyses on the marginal effective tax rate, which will enable us to evaluate the distortion in resource allocation.

There is considerable research on the marginal effective tax rate and the cost of capital. Since all of it cannot be introduced here, two papers will be summarized to see the implications on the neutrality of the corporation tax in the Republic of Korea. The first is a paper by Kwack and Yoo (1994). It extended the earlier results by Kwack (1985), which computed the effective tax rate essentially based upon a Jorgenson-Sullivan type analysis. The effective tax rates computed in that paper are presented in table 11.

The tax reduction effects, which are the differences between the statutory and effective tax rates, were fairly constant until the early 1970s. They then began to increase to a level above 10 per cent in the mid-1970s. This seems to be due to the reinforcement of tax support to key industries, particularly the tax holiday. From 1982, however, the tax reduction effect began to decrease again and has been stable since then. This decrease is mainly due to the abolition of the tax holiday.

What is of interest in this paper, however, is the distortion of resource allocation caused by tax incentives. That will be explained now. In table 13, effective tax rates by asset type are presented. As can be clearly seen from this table, the effective tax rates of buildings and construction are higher than those of machinery and equipment.

This is considered to be the result of the fact that most of the tax incentives were applied only to investments on machinery and equipment. However, since direct tax incentives such as the tax holiday (reintroduced in 1975) are applied regardless of asset type, effective rates of buildings and construction became fairly low during the late 1970s. Although the effective rates of buildings and construction have been higher than those of machinery and equipment, the actual costs of capital of the former have been lower than those of the latter. This was proven in two researches – Kwack (1985) and Kim (1991). It is argued that the tax holiday is the main reason behind this phenomenon (see Kim 1991 for details).

As a final discussion on efficiency, it should be mentioned that the country’s taxation has not served well as a device for correcting externalities. Environmental taxes have not yet been introduced. The Liquor Tax and Tobacco Consumption Tax are not high enough to correct the externalities caused by drinking and smoking. This is why a tax rate hike on these taxes is widely discussed these days. Also, taxes on petroleum are considered insufficient to correct the problems of pollution and

Table 12. Changes in the effective marginal tax rate (all assets)

Year	*Statutory tax rate[1] (A)*	*Effective tax rate[2] (B)*	*Effective tax rate[3] (C)*	*Tax reduction effect (A-B)*	*A-C*	*C-B*
1960	.330	.300	.319	.030	.011	.019
1961	.242	215	.237	.027	.005	.022
1962	.220	.189	.216	.031	.004	.027
1963	.275	.227	.269	.048	.006	.042
1964	.330	.281	.324	.049	.006	.043
1965	.330	.284	.324	.046	.006	.040
1966	.385	.328	.377	.057	.008	.049
1967	.385	.319	.372	.066	.013	.053
1968	.495	.436	.453	.059	.042	.017
1969	.495	.434	.449	.061	.046	.015
1970	.495	.438	.454	.057	.041	.016
1971	.450	.395	.414	.055	.036	.019
1972	.400	.311	.375	.089	.025	.064
1973	.430	.369	.437	.061	-.007	.068
1974	.430	.342	.435	-.002	-.005	.003
1975	.530	.451	.543	.079	-.013	.092
1976	.530	.428	.531	.102	-.001	.103
1977	.530	.380	.517	.150	.013	.137
1978	.530	.360	.503	.164	.027	.137
1979	.530	.359	.504	.171	.026	.145
1980	.530	.383	.508	.147	.022	.125
1981	.530	.405	.530	.125	.000	.125
1982	.504	.454	.502	.050	.002	.048
1983	.437	.394	.439	.043	-.002	.045
1984	.437	.378	.393	.059	.044	.015
1985	.437	.395	.397	.042	.040	.002
1986	.437	.386	.392	.051	.045	.006
1987	.437	.397	.398	.040	.039	.001
1988	.437	.397	.403	.041	.034	.007
1989	.437	.395	.404	.042	.033	.009
1990	.437	.402	.407	.035	.031	.004

Source: Kwack and Yoo, *Tax Incentives and Economic Development*, 1994.

Notes:
[1] Corporation tax rate x (1 + inhabitant tax + defence tax rate).
[2] Effective tax rate considering all the tax incentives.
[3] Effective tax rate considering depreciation allowance only.

congestion. In particular, the big difference in the special excise tax rates between diesel and gasoline result in a price difference and cause distortion.

For simplicity, the current tax system in the Republic of Korea leaves much to be desired. There are at least three main causes for this. First of all, there are too many taxes (31 as was shown in the previous section). Second, terms of tax codes are very difficult to understand by the general public. And third, too many tax incentives cause complexity so that even beneficiaries cannot know for certain how much benefit they can receive. Such complexity leads to a high cost of both compliance

Table 13. Changes in the effective marginal tax rate by asset type

		Buildings				*Machinery and equipment*			
Year	*Statutory tax rate (A)*	*Effective tax rate (B)*	*Effective tax rate (C)*	*Tax reduction effect (A-B)*	*C-B*	*Effective tax rate (D)*	*Effective tax rate (E)*	*Tax reduction effect (A-D)*	*E-D*
1960	.330	.313	.320	.017	.007	.274	.319	.056	.045
1961	.242	.228	.236	.014	.008	.184	.242	.058	.058
1962	.220	.203	.214	.017	.011	.160	.218	.060	.058
1963	.275	.252	.267	.023	.015	.184	.274	.091	.090
1964	.330	.304	.322	.026	.018	.235	.328	.095	.093
1965	.330	.304	.323	.026	.019	.243	.328	.087	.085
1966	.385	.342	.377	.043	.035	.291	.376	.094	.085
1967	.385	.343	.374	.042	.031	.267	.368	.118	.101
1968	.495	.463	.472	.032	.009	.414	.442	.081	.028
1969	.495	.459	.471	.036	.012	.414	.442	.081	.028
1970	.495	.465	.474	.030	.009	.415	.443	.080	.028
1971	.450	.418	.430	.032	.012	.368	.403	.082	.035
1972	.400	.295	.387	.105	.092	.296	.365	.104	.069
1973	.430	.368	.425	.062	.057	.343	.427	.087	.084
1974	.430	.350	.424	.080	.074	.326	.440	.104	.114
1975	.530	.437	.527	.093	.090	.397	.551	.133	.154
1976	.530	.450	.524	.080	.074	.363	.537	.167	.174
1977	.530	.396	.527	.134	.131	.323	.514	.207	.191
1978	.530	.347	.528	.183	.181	.323	.487	.207	.164
1979	.530	.350	.532	.180	.182	.310	.486	.220	.176
1980	.530	.372	.531	.158	.159	.333	.487	.197	.154
1981	.530	.376	.540	.154	.164	.357	.514	.173	.157
1982	.504	.467	.511	.037	.044	.434	.487	.070	.053
1983	.437	.404	.445	.033	.041	.379	.431	.058	.052

Source: Kwack and Yoo, *Tax Incentives and Economic Development*, 1994.
Note: See the note in table 11 for the meaning of tax rates.

and administration. These, in turn, become one of the sources of tax evasion and corruption.

III. SUGGESTIONS FOR FUTURE REFORM

Simplification of the tax system

As was pointed out in the previous section, a complex tax structure is one of the most distinguishing characteristics of the Republic of Korea, with 16 national taxes and 15 local taxes. It is argued that the country has too many taxes, and some taxes contribute little to revenue size, as shown in table 6. Excess profits tax and farmland tax are good examples. Some taxes do not play an important role as policy tools, such as the excessively-increased value tax. Also, some taxes, like the butchery tax, would be better named as fees than as taxes. Earmarked taxes are another source that makes the country's tax system so complicated. They are a sort of surtax levied on other tax amounts. For example, Special Tax for Rural Development is a surtax levied on the amount of exemption of corporation tax, individual income tax, customs duties, etc. The necessity for tax simplification has long been argued. In 1997, the Korea Institute of Public Finance proposed a tax reform to reduce the number of taxes from 31 to 13 (see figure A2 in annex and KIPF reform proposal for details).

Another source of the complex tax system is tax incentives. As was indicated, the structure of tax exemptions and reductions is very complicated and difficult to interpret. It leads to a low level of tax compliance by taxpayers. Therefore, it is necessary to abolish so many unnecessary incentives.

Reform of the VAT

Small businesses have been specially treated under the VAT system, since VAT was introduced in the country, as in most other countries with VAT. They were given special consideration to reduce the cost of tax compliance.

There are two types of special treatment for small businesses; one is a simplified method and the other is a special method. The simplified method is applied to small businesses that have between 48 million won and 150 million won in turnover per year. The value-added ratios for this group are predefined according to types of business by the tax authority. For example, manufacturing has a value-added ratio of 22 per cent, and restaurants and hotels have a value-added ratio of 50 per cent. These ratios are, in general, lower than the real value-added ratio. Thus the same value-added ratio is applied to the same businesses, irrespective of the real situation of each business. The other method is the special method, which is applied to small businesses with less than 48 million won in turnover per year. This group has a tax liability of 2 per cent of total turnover. It means that this group has a value-added ratio of 20 per cent, irrespective of the type of industry or personal situation. Within the special method, no tax liability is applied to groups that have less than 26 million won in total turnover per year.

Table 14 shows the number of taxpayers and the relative size of the tax base for the group receiving special treatment under VAT. In 1997, around 60 per cent of the total VAT taxpayers were considered small businesses and benefited from the special treatment in VAT. However, their share in the tax base was only 1.7 per cent. Thus, even though small business groups are very plentiful, their contribution is almost nothing. The reason for the large number of taxpayers receiving special treatment is that the tax authority is hard pressed to prove the exact size of total turnover for each business, since the businesses are more dependent on cash than on personal checks and credit cards. This is why self-employed businesses have a high level of under-reporting.

Invoices are very important records for cross-checking tax evasion under the VAT system. One distinguishing aspect is that small businesses receiving special treatment do not have to issue invoices with transactions. That is because their value-added ratios are already determined by the tax authority. Also, small businesses under special treatment do not want to receive invoices with their purchases, as they run the risk of letting the tax authorities know the exact size of their turnover if they receive invoices. It makes tax evasion possible for all taxpayers under the VAT system, since small businesses with no obligation of invoicing can be used as a method of tax evasion by others.

It has been widely criticized that the special treatment of small businesses in the VAT system is a crucial source for tax evasion. Although the special treatment was designed to help small businesses, an unexpected consequence is a high level of tax evasion. Therefore, special treatment must be abolished. It might have to be

Table 14. VAT return (taxpayers and tax base) by tax types (per cent)

	Taxpayers					*Tax Base*			
		Individual					*Individual*		
				Special					
Year	*Corporation*	*General*	*Simplified*	*Total*	*No tax*	*Corporation*	*General*	*Simplified*	*Special*
1993	5.2	34.6	_	60.2	11.1	78.3	19.7	_	2.1
1994	5.6	39.1	_	55.3	18.0	78.3	19.9	_	1.9
1995	5.9	43.7	_	50.4	34.3	79.1	19.3	_	1.6
1996	6.6	35.9	10.6	46.9	40.0	79.9	18.0	0.6	1.6
1997	6.6	34.3	16.7	42.4	36.9	81.2	16.1	1.2	1.5

Source: National Tax Administration, various years.

done gradually or step-by-step to lessen possible political resistance by the affected groups.

Comprehensive income tax

It has long been argued that comprehensive income tax is the most desirable form of income tax, setting aside the debate on comprehensive income tax vs personal expenditure tax. This "principle" must be true of the Republic of Korea as well. Income tax in the country, however, is far from comprehensive.

Currently, there are four different types of income – interest, dividend, retirement, and forestry – which are excluded from global income. Existence of such separately taxed income types has undesirable effects, particularly on equity. Since income tax is progressive, the total tax burden will be lower, the larger part of income is taxed separately. Thus, the introduction of the comprehensive income tax is desirable. In particular, inclusion of interest income is important in relation to real name based financial transactions.

Realization of self-assessment

All the tax systems became administered by self-assessment, after self-assessment was introduced in individual income tax in 1996. Even though the system was changed to self-assessment, the actual management has tended to be by the government. A typical example is that the tax authority makes predetermined tables that show the annual turnover and the level of income by type of business. Also, the tax authority has made this table available to taxpayers. Under this mechanism, taxpayers would report their turnover and income by just following their group guidelines of the amounts for their turnover and income. In addition, there is no incentive for the self-employed group to report their turnover and income honestly. Thus, predetermined tables must be abolished (or made unavailable to taxpayers), and the system should be switched to a true self-assessment system.

CONCLUSION

In this paper, the past tax reforms in the Republic of Korea have been described and evaluated. It has been shown that although many tax reforms have been done they have not been entirely successful. This does not mean that the current tax system as a result of such reforms is a failure. Rather, we have to interpret that there is much room for further development of the current system.

As was shown in section III, the country's tax system does not seem to contribute much to the provision of funds for public goods. Although it did contribute to the rapid economic growth of the country, the scope of the contribution has been limited. Factors that made these contributions possible – most notably tax incentives

– simultaneously caused some inefficiency to creep in and increased the complexity of the tax system. Also, there is much room for improvement as far as tax equity is concerned.

There are several proposals to simplify the tax system, such as reform VAT by abolishing special treatment, introduce a comprehensive income tax and realize a self-assessment system. Of course, these do not comprise the whole reform agenda, but are a major part of it.

In this paper, no attempt was made to add a new analysis or evaluation of past tax reforms. Instead, a survey of previous research was done. Conducting rigorous research – theoretical and empirical – on them is left for the future.

Since the economic environment of each country differs, one country's experience with tax reforms might not be directly applicable to other countries. The experience of the Republic of Korea, however, can be a good reference for tax reforms being undertaken, or likely to be undertaken, by other countries in the region.

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Annex

Tax incentives

In the early phase of the country's development, tax incentives played a relatively limited role in influencing business investment behaviour, largely because of the prevailing market imperfections. It was only after 1966, the year in which the National Tax Administration was established, that tax incentives began to play a significant role in the country's economic development.

In the 1970s, more diversified and sophisticated tax incentives were provided during the course of the so-called heavy industrialization phase, while incentives for export promotion were actually reduced in the early 1970s. During that decade, even though direct allocation continued to play a major role, in line with the increasing reliance of the government on market forces in the allocation of resources, tax incentive policies began to receive increasing emphasis. In 1974 there was a major tax reform and all major incentives were unified and rearranged under the title of "Special Tax Treatment for Key Industries" in the Tax Exemption and Reduction Control Law (TERCL).

In the 1980s, tax incentives began to be used less than before under the perception that they were being abused. First, some industries were deleted from the beneficiary list. The 60 per cent special depreciation system was completely abolished. The tax holiday option was abolished and the investment tax credit option was confined only to the machinery and electronics industries. At the same time, the investment tax credit rate was reduced to 6 per cent (10 per cent for investments using domestic capital goods) from 8 per cent (10 per cent). Effective from 1983, it was again halved to 3 per cent (5 per cent for investments using domestic capital goods) reflecting the downward adjustment of the statutory corporation tax rate.

After the Uruguay Round and the subsequent launch of the WTO, the aforementioned trend of the reduction of tax incentives was accelerated. Even with these and other unexplained changes, however, many tax incentives are still in effect today. For example, there are major incentives such as reserves for investment for small and medium-sized enterprises, investment tax credits, and various incentives for the induction of foreign direct investment.

Figure A1. The tax system of the Republic of Korea

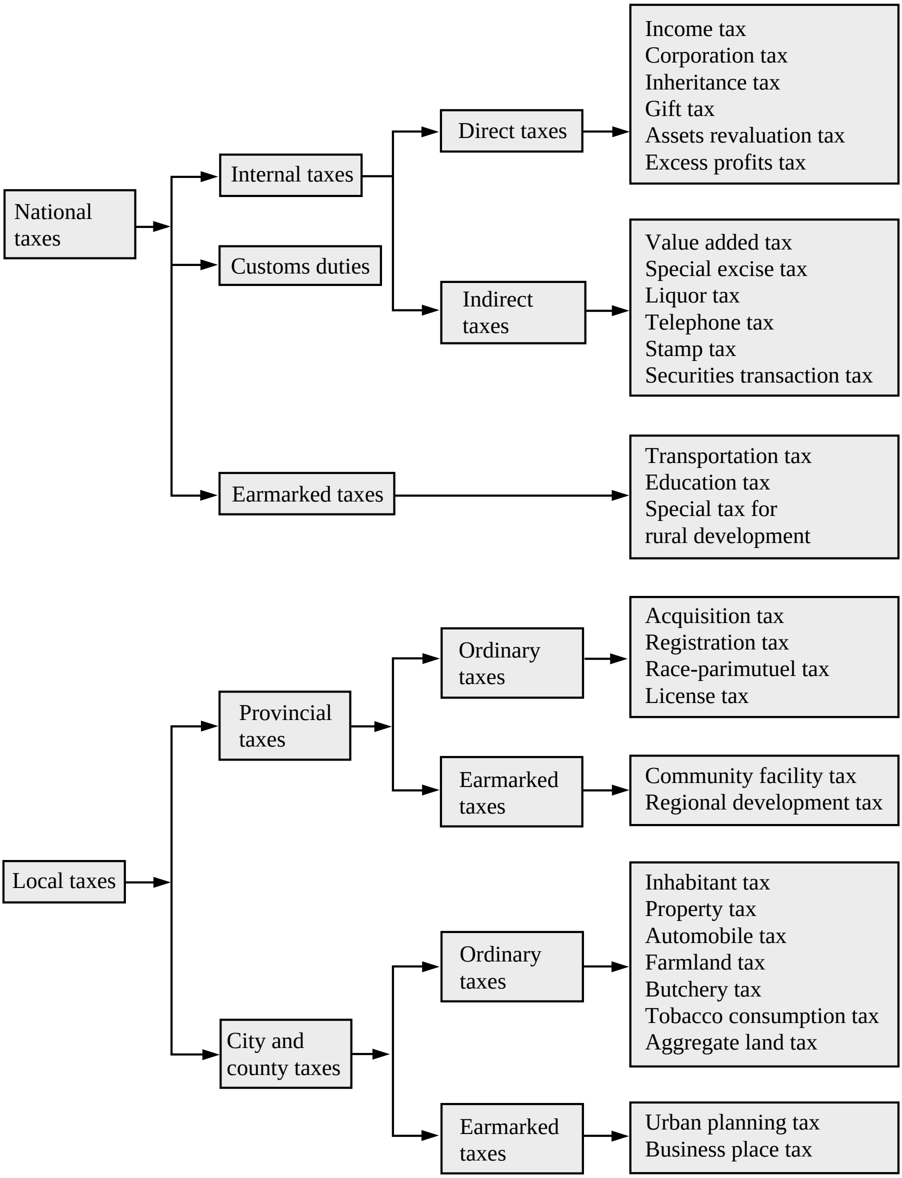
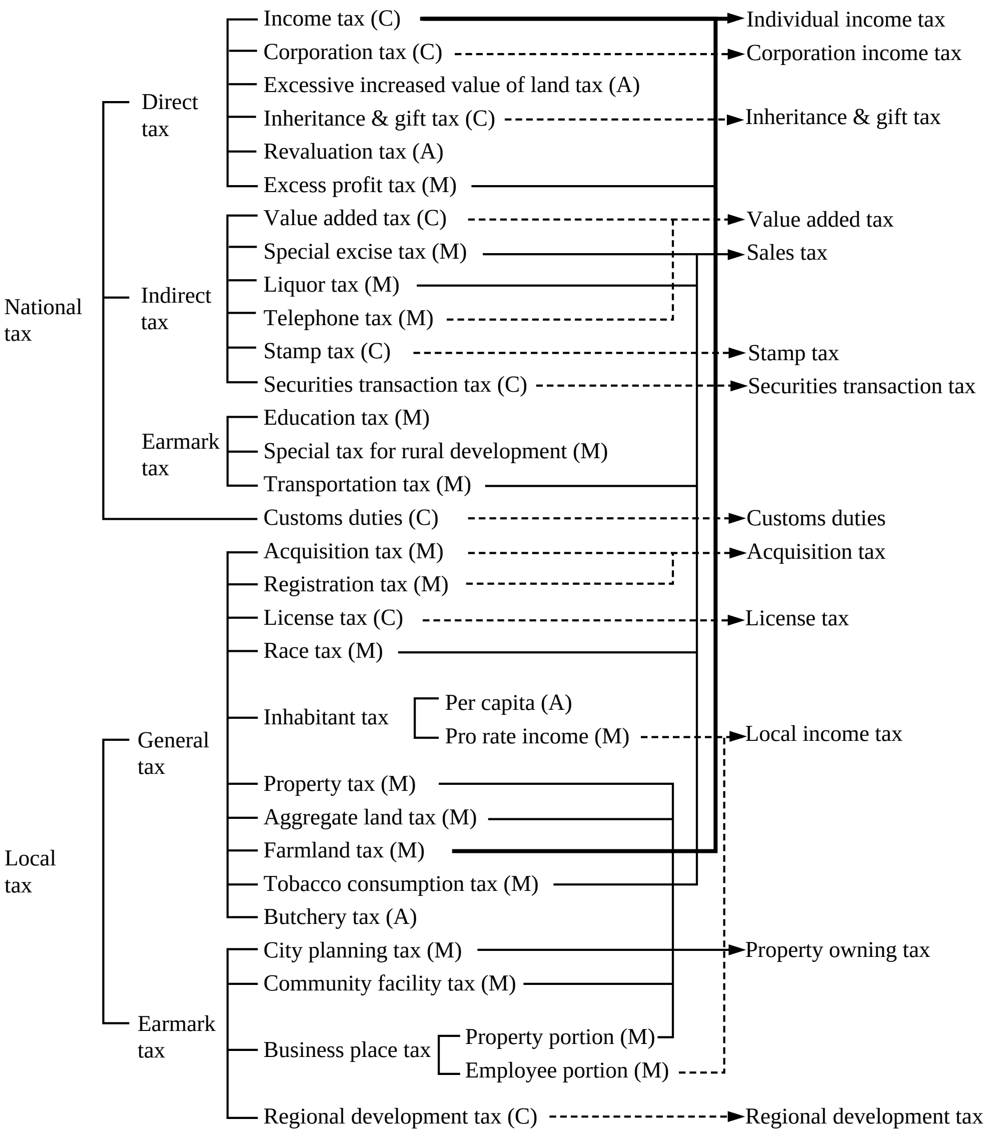


Figure A2. KIPF Reform proposal in the tax structure



Source: KIPF (1997).
Note: (C): Continuance; (M): Merge; (A): Abolition.